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ABSTRACT

The nature and scope of tax policies that affect higher education are sketched, concentrating on the provisions of the tax code that directly help families finance college costs. Attention is directed to: proposals to expand the range of tax benefits for higher education, the merits of existing and proposed tax schemes in times of reduced federal revenues, estimated taxes saved for individual families, and distribution of benefits by income level under different provisions. Additionally, tax breaks for higher education are compared with conventional student aid programs. Current tax breaks to help families finance college encompass two main approaches: permitting certain expenditures or investments to be excluded from the family's taxable income; and allowing parents to shift income from themselves to their children and thereby reduce the family's tax liability. Proposals for new tax breaks include: tax credits or deductions for current expenses, tax deductions for college savings, and tax-free income on college savings accounts. It is concluded that direct student aid programs are generally a more effective and equitable means of helping families meet college costs than are tax incentives intended to achieve the same objectives.
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Tax Provisions that Help
Families Meet College Costs

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Foreword

The costs of attending college in the early 1980s have been rising faster than general inflation while federal aid available to help students and families pay these costs has declined. The resulting squeeze is focusing new attention on tax devices that families can use to help save and pay for higher education.

Tax lawyers, investment counselors, and the media are fostering increased public awareness of such tax breaks, especially among middle- to upper middle-income families who are generally in the best position to take advantage of them. Shifting income from parents to children, for example, appears to be gaining popularity as a strategy to ease the burden of college costs by reducing overall family tax liability. A special lexicon ("Clifford Trusts" and "Crown Loans," for example) has evolved in an expanding and increasingly sophisticated realm of tax shelter activity. Current tax provisions can be used in a variety of ways to help indirectly with college expenses. And there are proposals in Congress to create new tax incentives for college financing.

This dimension of tax policy is not often considered in discussions of who pays and who should pay for higher education. Yet tax expenditures of the federal government as well as some states do affect how the bill for higher learning is divided.

Much has been written in the vein of practical "how to" advice on tax breaks for college. Little exists, however, that systematically analyzes the relationship between the income tax system and college financing or weighs the issues of equity and public policy implicit in current and proposed tax measures affecting college costs. This analysis is intended to help fill that gap.

The report broadly sketches the nature and scope of tax policies that affect higher education, concentrating in particular on the provisions of the tax code that directly help families finance college costs. The paper then discusses proposals to expand the range of tax benefits for higher education. The next section considers the merits of existing and proposed tax schemes in light of the amount of federal revenue lost, estimated taxes saved for individual families, and distribution of benefits by income level under different provisions. Finally, tax breaks for higher education are compared with conventional student aid programs.

Most of the cost and other estimates presented in the paper are necessarily rough approximations. Hard data are scarce on taxpayer participation and resulting federal revenue lost from various tax provisions. In areas where taxpayer interest and ingenuity seem to be growing, such as the shifting of income from parents to children, the approximations made here may well underestimate the extent of current activity.

Whatever the true magnitudes of use and cost, the analysis in this report raises a caution about the expansion of tax breaks for college financing. The analysis concludes that direct student aid programs are generally a more effective and equitable means of helping families meet college costs than are tax incentives intended to achieve the same objective.

Finally, a note of caution. This study is not intended as a guide for applying tax laws to individual circumstances. Tax legislation and Internal Revenue Service regulations change frequently, and readers interested in particular tax provisions discussed in the paper should seek legal counsel.

Lawrence E. Gladioux
Executive Director

March 1984

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Tax Breaks for College:

**Current and Proposed
Tax Provisions that Help
Families Meet College Costs**

Introduction and Summary

The federal tax code is frequently used to provide economic incentives to achieve policy objectives. Allowing a portion of capital gains to be excluded from taxable income, permitting deductions of mortgage interest payments, and providing tax credits for energy-economizing investments are just a few examples of how the tax system is used to create incentives for certain behavior.

In recent years, the term *tax expenditure* has gained currency as a way to describe provisions of the tax code that are exceptions to the "normal" tax rules and, thus, result in lost revenues to the federal government. These specialized tax provisions often substitute for spending programs, hence the term *tax expenditure*. The use and extent of tax expenditures has increased sizably. From 1975 to 1982 alone, federal revenues foregone through tax expenditures grew from less than \$100 billion (in 1975) to over \$250 billion (in 1982), according to Congressional Budget Office estimates. This rate of growth in the revenue loss from tax expenditure provisions substantially exceeded that of federal spending during these years.

Several factors account for the popularity of tax expenditures as compared to spending programs. Tax provisions can be less costly to the government and simpler to administer than an equivalent spending program. Tax incentives are sometimes more effective in meeting policy goals. Frequently, enacting a change in the tax code, especially when it is lumped together with a wide range of arcane tax modifications, is politically easier than passing a highly visible, new spending program.

Tax provisions also suffer from a number of limitations. Wealthier individuals and families, who are in higher tax brackets, benefit disproportionately when exclusions or deductions from income are allowed. Lower-income families, who are in lower tax brackets and generally do not itemize their deductions, benefit far less from special tax provisions. The tax code is also frequently an inefficient way to encourage certain behavior in that the taxpayers who are rewarded the most probably would have participated or invested regardless of any special provisions. Moreover, special tax provisions are often so complex or complicated that only a handful of taxpayers can understand the provision or can afford to pay for advice. Finally, items in the tax code are not reviewed by the same committees responsible for spending programs, thus adding to potential policy conflicts between spending and tax provisions.

The largest tax break for higher education is the tax-exempt status granted to most educational institutions because they are chartered as nonprofit organizations. Next largest is the provision that permits individuals to deduct charitable contributions from their taxable income. Most observers agree that tax breaks are both more efficient and more effective in providing incentives for charitable giving than a federal spending program with a similar purpose would be. Another, much smaller tax provision that aids colleges and universities is the exemption from federal income taxation of interest earned on bonds floated by states on behalf of colleges and universities. This exemption reduces the amount of interest that educa-

Tax Breaks for Higher Education

tional institutions must pay to obtain debt financing.¹ These tax breaks to institutions indirectly benefit students and their families in the form of lower tuitions.

Currently, the tax code also contains several provisions that directly help families finance college costs by reducing the family's tax liability. These provisions include the extension of personal exemptions for college-age dependents who are students, the exclusion of scholarship and fellowship assistance from taxable income, the deduction of interest on student loans, and favorable treatment of educational assistance for individuals in the workforce. There is also a set of devices such as gifts, trusts, and loans that allows wealthy parents to shift income from themselves to their children, thereby reducing the overall family tax liability.

A number of proposals have been made over the years that would expand the range of tax benefits for financing college costs. The three principal proposals now under consideration are the creation of tuition tax credits to offset partially the expenses for students in postsecondary education; deductions for contributions to special savings accounts that would be used to help pay for children's college costs; and tax-free income on investments in designated education savings accounts, as proposed by the Reagan administration.

Evaluating the Merits of Tax Provisions

Three criteria are frequently used to evaluate the merits of tax provisions: the amount of revenue lost to the federal government because a tax provision is on the books; the amount of taxes saved for individual families; and the degree to which tax savings are channeled to wealthier families, generally referred to as "the fairness issue."

Among existing tax provisions for meeting college costs, the most expensive in terms of revenue loss is the extension of the dependent exemption for college students—a provision that represents a loss of roughly \$1 billion in revenues annually. The next largest revenue loser is the exclusion of scholarship and fellowship assistance from taxable income, which costs slightly less than \$500 million each year. Provisions for gifts, trusts, and loans that allow parents to shift income-producing assets to their children result in an estimated revenue loss of approximately \$300 million each year. Other tax provisions are relatively small revenue losers. Altogether, these tax provisions currently cost the federal government close to \$2 billion in lost revenues every year.

The amount of taxes saved by individual families depends on several factors, including how much the family spends for education, the family's tax bracket, and whether the legislation limits the amount for which tax savings apply. The variety among individual and family circumstances makes it difficult to generalize about the value of an existing tax break. In general, however, the personal exemption for

1. Tax-exempt bonds have recently become a more widespread means of financing postsecondary education since a number of state agencies in the Guaranteed Student Loan (GSL) program now regularly issue such bonds to finance their lending activities. In addition, states and educational institutions concerned about federal loan cutbacks are developing alternative loan programs that would use tax-exempt financing to reduce their costs of borrowing and, in turn, allow them to charge below-market rates of interest to their borrowers.

students and the exclusion of scholarship assistance save the most taxes for the first \$1,000 spent for postsecondary education in any given year. But income shifting devices such as gifts or trusts have the greatest potential savings for individual families because higher limits apply.

Several patterns emerge with respect to who benefits from certain tax provisions. Excluding scholarships and fellowships from income is the existing provision that produces the greatest share of benefits for lower-income families. Provisions that allow parents to shift income from themselves to their children are the most advantageous for wealthier families: more than nine out of every ten dollars saved through such provisions likely accrues to families with incomes above the median. Most existing provisions benefit higher-income families more than the less affluent. Wealthier families tend to spend more on college and are in higher tax brackets so they receive more tax benefit per dollar spent. Overall, we estimate that about 65 percent of all tax benefits for college go to families with incomes above the national median.

Of the three types of proposed new tax breaks, none performs well on more than one of the three criteria used for evaluating the merits of tax provisions. Tax credits for current educational expenses appear to be the least regressive, particularly if the credit is refundable to families with little or no tax liability; however, the benefit offered to individual families under most proposals is relatively small compared to college costs and the revenue loss could be \$1 billion or more per year. If the amount of the credit is raised to increase the likely impact on behavior, lost revenues would be substantially higher.

Among the proposals under discussion, tax deductions for contributions to educational savings accounts have the greatest potential for generating tax savings. This type of approach could quickly become an important source of financing if it draws the kind of participation that Individual Retirement Accounts (IRAs) have demonstrated in recent years. But the overall revenue loss could be substantial—as much revenue could be foregone through such a tax deduction as is currently sacrificed through *all* existing tax breaks for families to meet college costs. Moreover, the equity of a tax deduction plan is suspect since only wealthier families can afford to invest large amounts in such a plan consistently and these families reap the greatest tax savings because of their tax bracket. The deduction plan could be made more equitable by requiring that a portion of the investment—5 percent in one proposal—be used to establish a scholarship fund for needy students. Even with this amendment, however, most of the benefits would still accrue to the well-off.

Allowing exclusions on income from investments in designated educational savings accounts might be a fairer approach if the maximum savings allowed under this plan were limited to families with incomes of \$40,000 or less, as the Reagan administration has proposed. But even with this limitation wealthier families would still probably benefit the most. In addition, the tax loss would grow once the program was in full swing, and the administration has probably underestimated the

number of families who would put funds into such an account before the child reaches college age.

As some observers have already noted, this proposal is unlikely to result in a satisfactory return on the dollars invested. In effect, the tax-free income approach differs very little from current gift or trust arrangements that allow parents to transfer assets to their children and thereby pay little or no tax on the income from those assets. Parents would likely shift some of what they already save into these educational savings accounts because their income would be tax free, with little net increase in overall savings.

Tax Provisions vs. Student Aid

Tax breaks are only one way the federal government can lower the amount students and their families have to pay for college. A more obvious way to lower the price is through student assistance programs. In fiscal year 1982, the federal government spent approximately \$7 billion for student aid compared to about \$2 billion in revenue loss incurred through tax breaks for college in that year.

Student aid programs usually provide more assistance to families who participate in them than tax provisions do. A grant directly reduces the price that students and their families pay. Families have to save or spend substantial amounts to net a tax break equal to that of a direct grant. The implicit government interest subsidy for loans is also more valuable to individual families than most tax breaks.

Finally, there is the question of who benefits. Student aid programs are much more sharply targeted to lower-income families than are tax provisions. For example, 10 percent or less of the benefits in the Pell Grant program go to families above the median whereas the vast preponderance of current and proposed tax breaks go to wealthier families. Even in the student aid program most aimed at the middle class—Guaranteed Student Loans—more than half of the borrowers come from families with below median incomes.

Student aid programs can target benefits to families with financial need more effectively than any of the new proposed tax provisions. These advantages should give pause to those who advocate an expansion in the range of tax breaks for college.

Current Tax Breaks

Tax breaks currently on the books to help families finance college fall into one of two general categories. One type permits certain expenditures or investments to be excluded from the family's taxable income. The other allows parents to shift income from themselves to their children and thereby reduce the family's tax liability.

The Extension of Dependent Status. The income tax personal exemption that parents may claim for their children generally ends when the child reaches the age of 19. But under a legislative provision passed in 1954, parents may continue to claim this exemption—presently worth \$1,000—if the child is a full-time student and if the parents continue to provide at least one-half of the student's support. Extending the dependent status enables a student to continue to be claimed as an exemption twice—once by the parents and then again by the student.²

Exclusion of Scholarship and Fellowship Assistance. In 1954 the federal tax code was revised to exclude fellowships and scholarships from taxable income. Payments for teaching, research, or other part-time employment, however, are counted as income to the extent that the work is not a required part of the educational program. The premise here is that scholarships and fellowships are similar to gifts and, thus, should not be included as student income; if payment is received for services rendered, then it is income.

The distinction between employment income and a fellowship, however, blurs when payments are a combination of compensation and a fellowship. For example, if a graduate student receives a fellowship but also serves as a teaching assistant, how much of the fellowship is properly considered income to the student? This question also frequently arises when medical students become residents. Often, the issue is resolved by the educational institution declaring that assistantships are a required part of the educational program and payments should not be considered income. If the institution makes no such declaration, the recipient may then be asked to differentiate between income earned for teaching and funds received as a fellowship.

Deductions for Interest on Student Loans. Taxpayers who itemize their deductions may deduct the interest paid on student loans from their taxable income just as they exclude other interest payments. Most student borrowers, however, are not able to take advantage of this provision because they do not itemize, at least in the first several years after they graduate or leave school and begin repaying their

Income Exclusions

2. To qualify, the child must be a full-time student for at least five months of the year. IRS instructions further specify that "the school must have a regular training program, a regular course of study, and a regularly enrolled body of students in attendance." Participation in on-the-job training programs and correspondence schools does not qualify. The minimum standard deduction (\$2,300 for single persons) applies only once, either on the parents' or the student's tax form.

loans. If parents borrow to finance their children's education, they are more likely to itemize and thus derive a tax benefit from the interest payments.

Educational Assistance for the Workforce. Employers presently offer a variety of plans that help employees and their families pay all or part of their tuition and related educational costs. In addition to direct tuition payments, there are mechanisms such as income deferral and contributions to employee reserve funds for designated expenses, such as education, that permit employees to postpone or reduce their tax liabilities.

Before 1978 the tax treatment of educational assistance provided by employers was subject to controversy. In general, the IRS ruled that such employer payments could only be regarded as tax-free income to the employee if the education helped employees to perform their current jobs. If the education helped employees to change jobs, then the payments were considered income to the employee. Legislation passed in 1978 provided that employer payments for education (except for hobby or sports courses), regardless of their impact on the employee's job status, could be excluded from taxable income. The legislation enacted in 1978 also sought to clarify which factors must be present for employer-financed educational assistance to qualify for the most advantageous tax treatment. To qualify, the educational plan must be written, must be available to all employees, and must offer employees educational aid as an added benefit, not as a replacement for compensation.

These provisions expired at the end of 1983, creating uncertainty about the tax status of employer-paid education benefits. Legislation has been introduced that would establish the 1978 employer educational assistance provisions as a permanent part of the tax code. Backers of such legislation may also try to stipulate that employer payments made for the educational costs of the employee's spouse and dependents, currently regarded as taxable income in most cases, should be non-taxable in the future.

Many colleges and universities assist faculty (and sometimes other employees) in financing their children's education. This form of employer-paid educational assistance, one of the best known and most common, is considered to be scholarship or tuition remission and, thus, not taxed as income. Institutional tuition plans vary widely in the amount of payment, whether it applies to other institutions, and the degree to which different groups of employees are covered. The IRS has threatened periodically to rule that this fringe benefit should be considered in-kind income—similar to free or reduced rental housing—and, thus, should be taxed. Thus far, however, academicians, who would face substantially higher tax liabilities if the rules were implemented, have thwarted IRS efforts to issue a tuition benefits regulation. These professors and others point out that their incomes and financial planning have been predicated on the availability of this benefit.

Employees who incur out-of-pocket expenses for their further education may, in some cases, deduct these payments from their income. To qualify as a deduction from income, however, the educational program must be aimed at maintaining or improving the skills of employees in their present jobs. Like the rules that existed

before 1978 for employer-paid expenses, if the education would have the effect of helping an employee change or upgrade jobs, the education payments are not deductible.

While excluding items from taxable income is usually the most advantageous tax strategy, another means for reducing tax liabilities is to shift taxable income from parents to children. The tax advantage here derives from the fact that parents generally pay taxes at a higher rate than do their children during those years when the children are attending school. Most youths, before their working years, do not have sufficient income to pay any income tax, although as parents shift income-producing assets to their children, an income tax liability may result. This tax advantage may be offset partially if the family applies for financial aid since assets in the student's name are weighed more heavily than parental assets in assessing family ability to pay under current need analysis procedures.

Gifts. The most direct and reliable way for parents to shift taxable income and to save for college expenses is to give assets to their children. Through the gift mechanism, parents can shift a wide range of assets to their children (up to statutory limits) without being subject to the federal gift tax. Once the gift is made, income from these assets is reported as the child's and is taxed as such.

To qualify for this tax treatment, however, the assets must be in the child's name, as provided for in the Uniform Gifts to Minors Act, which governs gifts to children. Under this legislation, the assets pass outright to the children when they reach the age of majority (as defined in the jurisdiction where the gift was made).

The Economic Recovery Tax Act of 1981 enhanced the gift approach in two ways. First, the annual limits on gifts not subject to the federal gift tax were raised to \$10,000 per child (from the previous limit of \$3,000) for each parent. In addition, the 1981 legislation provided an unlimited gift tax exclusion for tuition paid directly to an educational institution on behalf of another individual. (This unlimited exclusion also now applies to payments to a medical facility for the health care of another.)

Trusts. For most families, gifts should suffice as a means for transferring tax burdens from the parents to children. But for some wealthier families, the gift approach does not provide sufficient coverage for the assets they wish to use for their children's education. In addition, some parents are apparently leery of what their children may do with the funds once the assets are transferred.

Parents with these concerns could choose to transfer assets into a trust to be used for college costs. For the assets placed in trust to qualify as the child's income, the assets may not revert to the parents in fewer than ten years and a day from when the trust was established. After the ten-year period, the parents (or whoever contributed assets to the trust) may reclaim the assets. The earnings from the assets placed in trust may either be reinvested or provided directly to the child.

One small complication in the trust arrangement is that the future income on the assets transferred into the trust is considered a gift for the purpose of calculating

Shifting Income from Parents to Children

the federal gift tax liability. But the annual amount that can be placed in trust before the expected future income from this transfer exceeds gift limits is quite large by most parents' standards. Under the IRS rules for estimating future income and with the expansion of gift limits in the 1981 tax legislation, a couple can place a minimum of \$30,000 of assets a year into a trust for each of their children without violating the annual federal gift limitation.

Loans to Children. One drawback to a gift or trust arrangement is that parents do not have access to the money if their financial circumstances change, or if the child is irresponsible in meeting financial or other obligations. Parents with this concern can simply loan the money to the child. Repayment of the loan can stretch over a specific length of time, like ten years, or can be specified but indeterminate, such as five years after the children finish college. Or the loan can be payable on demand by the parent. There is also tremendous discretion in what interest rate is charged, generally ranging from zero to some form of market-based rate.

An increasingly discussed means for financing college costs is the Crown Loan, an arrangement in which parents lend money to their children at no interest. Such loans are named for Lester Crown who successfully challenged the IRS in the Seventh Circuit Court regarding the legality of these arrangements. The child invests the borrowed funds and pays taxes at a much lower rate than the parents. The IRS argued that the difference between market rates of interest and what the parents charge—in this case, zero—amounts to a gift.

The initial Circuit Court ruling won by Crown was that the uncharged interest does not constitute a gift if the child must repay the loan on demand by the parent. The Supreme Court in February, 1984, however, sided with the IRS in another case involving interest-free loans between family members and ruled that the uncharged interest should be regarded as a gift. Although the case did not involve a loan for educational purposes, the Supreme Court ruling will apply to Crown loans as well and will no doubt reduce their appeal as a means for financing college costs.³

All of these possibilities for transferring income from parents to children—gifts, trusts, and loans—can be financed through capital already accumulated by the parents or through borrowed funds. For example, parents can borrow from a bank at prevailing rates or they can use the loan provisions in their insurance policies or pension funds. In turn, they can use these funds to make gifts, create trusts, or provide loans to their children. The interest that the parents pay on the loan is deductible, and the income from the investment of the assets would be taxed at the rate which applies to the children's income.

Conversely, a gift or trust may be used as a loan back to the parents. For example, parents can make a gift to their child and the child lends the money back to the parents, who then pay interest on the loan to the child. Under such an

3. Even under the new ruling, the \$10,000 annual gift tax exclusion permits parents to lend a large sum—for example, a cumulative loan of \$100,000 at a foregone interest rate of 10 percent—before the gift tax would apply.

arrangement, the parents can deduct these interest payments from their income and the interest paid on the loan is taxed at the child(ren)'s lower rate. Obviously, the IRS, which tends to view loan back arrangements as merely paper transactions, scrutinizes this activity carefully.

Many other options exist for high-income or high-asset families who are seeking income shelters. These other possibilities include:

- Providing funds so that the children can invest in real estate, such as a condominium or house near campus. In some cases, the parents purchase the real estate, charge their child a nominal rent, and then claim deductions for depreciation and maintenance expenses, as well as property taxes and interest paid on the mortgage.
- Creating a charitable remainder trust that allows parents to take a charitable deduction on assets placed in trust, with the children to receive income from the trust for a specified period of time, after which the remaining assets are given to charity. Some colleges are now beginning to lobby wealthier families to use this device as a way to help finance college costs and to designate the college attended as the charitable institution to receive the remainder of the trust.
- Investing funds in an oil-drilling operation. After the parents deduct intangible drilling costs from their income, the assets would be shifted to the child who would declare the income if the drilling were successful.

Many of these more sophisticated plans are still subject to IRS scrutiny and involve a great number of technical, legal, and financial questions that fall outside the scope of this paper.

Proposals for New Tax Breaks

New tax breaks to help finance college have been proposed for several reasons. College costs continue to grow—a private college education at some institutions now costs more than \$12,000 a year—and parents continue to look for help in meeting these costs. Uncertainty over funding for grant and loan programs heightens the search for new sources of funds. Moreover, the higher-income parents who can benefit most from tax-related savings are generally not eligible for the more traditional student aid programs. In addition, their previous full eligibility for Guaranteed Student Loans was curtailed in the 1981 legislation that required an analysis of financial need for families with incomes above \$30,000.

Several legislative proposals for new tax breaks are currently under consideration.

Tax Credits or Deductions for Current Expenses

One of the most persistent ideas in educational finance has been the notion of providing tax credits or deductions directly to parents to offset a portion of tuition costs. Popular sentiment holds that a tax credit is the proper structure for such an incentive. A credit would allow taxpayers from all tax brackets to derive the same tax advantage while a tax deduction would disproportionately aid families in the highest tax brackets.

Tuition tax credits have been proposed for all levels of education: elementary, secondary, and postsecondary. Some legislative proposals focus only on elementary and secondary schools while others include the postsecondary level. The Senate has passed a tuition tax credit bill a number of times during the past fifteen years, but several controversial issues have blocked its final enactment. At the elementary and secondary level, the question is whether a credit that would primarily benefit parents who send their children to religiously oriented schools jeopardizes the constitutional mandate of separation of church and state. Another concern is that the credit would speed the flight toward private schools that charge tuition, thereby adversely affecting public school enrollments.

Several states have enacted tax credits or deductions to offset tuition costs of elementary and secondary education. If the tax advantage applies to both public and private enrollments, the courts appear inclined to allow the provision to stand. This was the basis for a Supreme Court decision in 1983 that validated a Minnesota tax deduction even though the vast preponderance of benefits go to private school families.

At the postsecondary level, many observers are concerned that a tuition tax credit for college education would primarily benefit middle- and higher-income families and thus detract from the goal of equal opportunity. They also argue that the revenue loss—probably more than \$1 billion—would be ineffectual in that the credit would not be sufficient to change the behavior of the families who benefit.

Legislative proposals for tuition tax credits have taken a number of forms since the issue was first debated. Under one currently popular plan, credits of up to \$250 for students at the elementary, secondary, and postsecondary undergraduate levels would be allowed in the first year; the maximum credit would eventually rise to

\$500 per year per child. Coverage would also be expanded to graduate and part-time students several years after enactment.

President Reagan has already declared his support of tax credits for elementary and secondary schools. The administration also supports tax credits at the postsecondary level, once budgetary pressures recede.

Tuition tax credits would offset a portion of educational costs as they are incurred. In recent years an alternative to tuition tax credits has been discussed that would allow parents to deduct some of the funds they save for their children's college costs. Two possible formulations of tax-protected saving for college have been proposed. One would allow funds invested in an Individual Retirement Account (IRA) to be used for education. The other plan would authorize a new tax-sheltered education savings account, similar to but separate from IRAs.

Tax Deductions for College Savings

Expanded Use of IRAs. Individual Retirement Accounts were first authorized in the Employment Retirement Income Security Act (ERISA) of 1974 as a means for individuals not covered under employer-sponsored pension plans to invest in a tax-sheltered retirement plan. Through an IRA, funds may be invested in a wide range of assets including savings accounts, certificates of deposit, mutual funds, stocks and bonds, and others. Annual contributions to the IRA up to statutory limits are deductible, and the income earned on these assets cannot be taxed. The money is taxed when it is withdrawn from the IRA after the individual reaches the age 59 ½, generally at a lower tax rate than when the funds were contributed.

The use of IRAs is growing because of two provisions in the Economic Recovery Tax Act of 1981. First, the limits on annual contributions were raised. Second, individuals covered under private pension plans are now eligible to create their own IRAs as well, thus greatly expanding the population able to benefit from the IRA provisions.

The tremendous size and future growth of IRAs and their obvious political popularity have made this tax-sheltered vehicle a tempting target for various sectors of the economy. The housing industry, for example, has argued that families should be able to use funds in their IRAs to invest in home purchases without paying taxes on transfers from the account. Similarly, there has been talk in the educational community that paying for college costs would be an appropriate use of IRAs. Thus far, however, the prevailing sentiment is to restrict the use of IRAs to their initial purpose—saving for retirement.

College Savings Accounts. Several bills have been introduced in Congress that would create tax-sheltered accounts to encourage parents to save for their children's education. Like the IRA, these plans would allow parents to reduce their taxable income through investments. Funds contributed up to annual limits, and the income from these investments, would not be taxable. Money could then be withdrawn to help pay for tuition and other allowable costs of education, perhaps including room and board.

Plans vary in how withdrawals from the account would be taxed. One approach is to tax the parents when the withdrawals are made, although this may defeat the purpose of the legislation since parents with college-age children are generally in their prime earning years and thus face their highest tax rates. Another possibility is to tax the children when money is withdrawn. But since most children will not have sufficient income to be subject to taxation while they are in school, this arrangement would effectively make contributions to the education savings account totally tax free. Still another approach is to tax the children over a period of time after they leave school for the payments made on their behalf while they were in school.

The Citizens League of Baltimore was one of the first groups to advocate such a plan. Under the Citizens League approach, up to \$2,000 per student could be deducted each year from taxable income. Funds withdrawn to pay for education would be taxed as the student's income over a ten-year period after the student graduated or left school. Another feature of the Citizens League plan would require that 5 percent of the contributions to the education savings accounts be placed in a state fund for grants to needy students. This mandated "set-aside" for scholarships, which could be deducted by the parents as a charitable contribution, would ensure that lower-income students could also benefit from these savings accounts.

New York appears to be the only state that currently has a program allowing tax deductions for education savings. Under New York's PASS (Parent's and Student's Savings) plan, state residents can deduct up to \$750 from their state taxable income annually for contributions to a custodial account. Earnings on the account are also not subject to state taxation. Students may use the money to pay for postsecondary education anywhere in the United States; after the students finish their education, they are then obligated over a period of years to report as taxable income the distributions they received while in school.

Senator Robert Dole, among others, has introduced similar legislation in the 98th Congress. The Dole bill (S. 16) would allow families to deduct up to \$750 each year from their federal taxable income for contributions to an education savings account. Students would pay taxes on withdrawals from the account over a ten-year period after they left school.

Tax-Free Income on College Savings Accounts

The Reagan administration has proposed another type of tax break for college savings. Under the Reagan plan, parents could deposit up to \$1,000 a year for each of their children in an education savings account. Unlike other proposals to provide tax deductions for college savings, the Reagan approach would not allow a deduction for contributions to the savings account. Instead, only the income from the assets contributed would be exempted from federal income taxation. No tax, however, would be imposed when funds were withdrawn to pay for college costs.

In order to prevent wealthier families from using these new education savings accounts, the administration proposes that only families with incomes of less than \$40,000 could invest the full \$1,000 each year and still have the income from these investments protected from taxation. For families with incomes of \$40,000 to

\$60,000 the limit on annual contributions would be reduced on a sliding scale; families above \$60,000 would not be eligible at all.

This tax-free approach differs very little from the current provisions that allow parents to shift income to their children. Under both approaches parents avoid paying taxes on the income earned on designated assets. One difference between the two, however, is that those children who have income tax liabilities—most do not—must pay tax on income gained from gifts, trusts, or loans; the Reagan plan would impose no tax on the children under any circumstance. On the other hand, considerably more assets can be shifted to children under existing gift and trust provisions than under the \$1,000 limit proposed in the Reagan administration plan.

Another difference between these approaches may become apparent if the family applies for student aid. Under the Reagan plan, funds in the savings account would still be treated as assets of the parents. The current need analysis methodology would call for lower contributions from those assets than from gifts of similar size to the children. This difference in treatment occurs because assets in the children's name are assessed at a much higher rate in the needs analysis procedures than are parental assets.

Two other uses of the tax system for financing college costs have been proposed. One is to allow or require the repayment of student loans as part of the federal income tax system, either through regular withholding or in the taxpayer's annual submissions. Another proposal would allow individuals, once they enter the work force, to depreciate all or a portion of the costs they paid for college.

IRS Collection of Student Loans. Proposals to link repayments of student loans with the federal income tax system stem from two concerns about current arrangements. First, high default rates for student loan programs threaten their credibility; enforcement mechanisms built into the tax system would greatly reduce or eliminate defaults. Second, a direct link with income tax information would more readily allow for repayment schedules that are tied to the income and capability of borrowers to repay their loans once they leave school.

The growing volume of student borrowing will probably increase support for income contingent repayment plans if loan obligations strain the ability of many borrowers to repay, especially in the years immediately following graduation. Representative Thomas Petri, Senator Paul Tsongas, and others in the 98th Congress have proposed the Income-Dependent Education Assistance (IDEA) Act, which advances the concept of income-contingent, tax-based repayment of student loans.

Depreciating Educational Costs. The notion of depreciating educational costs is adapted from the tax system as it applies to corporations. The corporate tax structure allows companies to deduct, over a period of time, the costs of acquiring physical capital, that is, plant and equipment. Why shouldn't individuals be allowed to deduct or depreciate their costs of acquiring human capital—educational and training expenditures—just as businesses now do in the acquiring of assets?

Other Tax-Based Approaches

Allowing the depreciation of educational costs once individuals enter the work force might substantially affect their decisions about whether to invest further in education and whether borrowing is a good way to finance the costs involved.

Both of these proposals—repaying student loans through the tax system and depreciating educational costs—face stiff opposition. The Internal Revenue Service appears determined not to get into the business of collecting on student loans. The amount of revenue loss that could result from allowing depreciation of educational costs dwarfs all other current and proposed tax breaks for meeting college costs. Both proposals would likely involve a major restructuring of all student aid and tax provisions.

Evaluating Current and Proposed Tax Breaks

Several measures are commonly used to evaluate tax provisions. One criterion is the amount of revenue lost from special tax treatment. A related measure is the amount of taxes saved by individual families. Another perspective is the fairness of tax provisions, which can be evaluated by determining or estimating which income groups realize the greatest tax savings. In the following discussion, these criteria are used to examine both existing and proposed tax provisions for college. In addition, student aid, the other major method of government assistance for postsecondary education, is compared to tax breaks.

A full-fledged economic analysis of tax provisions related to college financing, however, should also include an assessment of how such provisions affect enrollment patterns and behavior, that is, the "bang for the buck." To obtain such an assessment, the benefits of a particular provision must be compared to its cost. Benefits would be measured by estimating how many and which students change their decisions about whether and where to attend college because a particular provision is enacted. Costs would most likely be measured in terms of revenue loss. Similarly, the effectiveness of student aid programs should also be analyzed.

But little is known about how the cost of college—and changes in the cost—affect an individual's decision to attend. Empirical studies of the degree to which price affects enrollment behavior have been inconclusive. Without such knowledge, it is not possible to estimate with any precision the impact of tax or spending programs on enrollments.

Because of these data limitations, this analysis estimates the size and distribution of tax and spending provisions based on postsecondary enrollments and costs as they exist today. The potential impact of various provisions is estimated only in a few cases and the estimates are based mostly on speculation.

Estimates of revenue loss from tax provisions have become a fixture of the political process; both the Treasury Department and the Congressional Budget Office now regularly produce reports on existing tax expenditures. Congressional budget and tax debates frequently include a discussion of whether tax expenditures should be increased (to provide greater incentives for certain economic behavior) or decreased (to provide additional revenues for the federal government and thus reduce the deficit).

Table 1 indicates that approximately \$1.85 billion in tax expenditures was provided in fiscal year 1982 for college costs. Most of these estimates are from the Congressional Budget Office; where CBO figures were not available, the author has provided estimates. As the table shows, the largest tax provision to help families pay for college is the extension of the personal income tax exemption for children if they remain students. In 1982, over half of the revenue loss attributable to helping families meet college costs was for this provision. The next largest tax break is the exclusion of scholarship and fellowship assistance from taxable income; it costs almost \$500 million annually. The deductions for interest on student loans and job-related educational assistance are relatively small revenue losers.

Revenue Loss

**Table 1. Revenue Loss From Tax Provisions for Financing College Costs,
Fiscal Year 1982**

Existing Provisions	Loss (in millions)
Extensions of dependent status for college students	\$ 995
Exclusion of scholarship and fellowship assistance	465
Deduction of interest on student loans	50*
Job-related educational assistance	40
Shifting income from parents to children	<u>300*</u>
Total revenue loss from existing provisions	\$1,850
Proposed Changes	Loss if fully implemented in 1982
Tax credits for current tuition expenses—maximum \$250 credit	\$1,000*
Tax deductions for college savings—\$2,000 maximum annual contribution	1,500*
Tax-free income on college saving accounts—\$1,000 maximum annual contribution	500*

Source: Congressional Budget Office and author's estimates.

*Author's estimates. Other figures are Congressional Budget Office estimates.

No solid information exists on the degree to which parents are using gifts, trusts, and loans to transfer income to their children to help finance college costs. Parents can use these income-shifting devices before the child reaches college age, thus increasing the size of the potential population that can benefit. The estimate of \$300 million in Table 1 assumes that approximately 2 million families annually use at least one of the existing income-shifting plans, predominantly gifts. To the extent that the use of these income-shifting devices may be growing rapidly because of increased media publicity about their availability, the estimates presented here may understate the current amount of tax revenues lost from these provisions.

For proposed new tax breaks, the size of a particular revenue loss depends on the exact formulation of the proposal. A tuition tax credit of up to \$250 for college expenses would cost approximately \$1 billion in annual revenue loss. A larger maximum of perhaps \$500 or \$1,000 would boost the annual revenue loss to \$2 billion or more.

The amount of revenue loss from tax deductions for college saving depends both on the maximum set-aside amount and the degree to which parents decide to participate. If the annual limit on contributions were \$2,000—the same as Individual Retirement Accounts—the annual revenue loss could be \$1.5 billion. A lower limit on annual contributions—such as the \$750 suggested in Senator Dole's bill—would put the revenue loss in the range of \$500 million each year. In New York, according to one recent survey, only 5 percent of students and their families use the PASS provisions (which are similar to Senator Dole's bill). But state income tax rates, even in New York, are substantially lower than federal rates, and a federal savings deduction plan would most likely have more participants than a similarly-structured state plan.

The administration estimates that its proposal to allow tax-free income on education savings accounts would cost less than \$50 million in its first year and about \$360 million after five years of operation. When the proposal is fully implemented, however, annual revenue loss may be substantially higher than administration estimates. Many families might decide to shift some of what they already save into these designated accounts to reap the tax advantage. Funds might also be shifted from gifts, which parents cannot control, to these special savings accounts, which they can control. Although these accounts would probably not substantially increase the total dollars set aside for college, they would increase the revenue loss to the government. If tax-free savings accounts had been fully operational in 1982, by our estimates, they would have cost approximately \$500 million in additional foregone federal revenues.

Total revenue loss *per se* does not adequately represent the impact that tax provisions can have on decisions about whether and where to attend college. For any given revenue loss, the amount of tax savings for individual families must be analyzed.

The amount of taxes a family saves from any particular tax provision depends on several factors including whether the legislation limits the tax dollars that can be saved, how much is spent or invested, and the family's tax bracket. For example, the \$1,000 exemption for student status is worth \$500 to a family in the highest tax bracket (50 percent marginal tax rate). Similarly, excluding \$1,000 in scholarship assistance or employer-paid tuition from taxable income results in a \$500 savings for the same family. By contrast, if parents give \$1,000 in income-producing assets to their children, approximately \$200 to \$400 of future taxes would be saved, depending on how long the money is saved and how much income is earned.⁴ The amount of tax saved by deducting interest on student loans is even smaller—about \$100 in present value for a \$1,000 loan—because the savings do not occur until the loan goes into repayment, which lowers the value of the taxes saved when measured

Tax Savings for Individual Families

4. Estimates of taxes saved in future years are discounted to a present value basis to reflect the impact that inflation may have on the value of tax dollars saved in future years. All such subsequent estimates are computed in the same manner.

in today's dollars. In addition, when most student borrowers repay their loans, they are in relatively low tax brackets thereby further reducing the tax break for those who are able to itemize their deductions. Loans to parents would likely yield more immediate and larger tax savings for interest deductions than loans to students.

These *existing* tax breaks are less valuable for middle- and moderate-income families. The \$1,000 exemption for college students is worth only \$200 in tax savings for a family in the 20 percent tax bracket, compared to the \$500 savings for the highest bracket family. A gift of \$1,000 might be worth \$100 or less in taxes saved for moderate-income families, since the difference between the parents' and children's tax rates is substantially smaller than for wealthier families.

Among *proposed* tax breaks for college, deductions for savings accounts appear to be the most beneficial for high-income families while families of more moderate income would generally receive the largest benefits from tuition tax credits. Taxes saved in the savings deduction plan include both the exclusion for initial contributions and the tax-free status of the investment income until the funds are withdrawn. These savings would be offset a little by the taxes that students might have to pay once they leave school and are taxed on the withdrawals from the account. If a parent were to set aside \$1,000 in such a plan several years before the child entered college, the present value of taxes saved could exceed \$700. For a moderate-income family, the taxes saved would be substantially less—perhaps a present value of \$200 in taxes saved from a contribution of \$1,000.

In contrast, under most of the proposed tuition tax credit plans wealthier families do not realize as great a tax savings since the credit is a fixed and limited amount that does not vary according to the family's tax bracket. For more moderate-income families, however, tuition tax credits may be the most valuable tax break. For families in a 20 percent tax bracket, the present value of taxes saved for a \$1,000 contribution to a savings account or a tax-free income account might be \$200 or less, whereas the tax credit would be worth \$250 even in the least generous proposals now under consideration. The difference in the relative value of tuition tax credits compared to other types of tax breaks is that high- and moderate-income families receive the same tax savings from a tuition tax credit, whereas the value of other breaks depends in large measure on the family's tax bracket.

The taxes saved through the Reagan administration's proposed tax-free income approach would be similar to what is saved through existing income-shifting devices such as gifts and trusts. At the \$1,000 cap on annual contributions as proposed, high-income families might receive a tax benefit in present value terms of \$200 to \$400; for moderate-income families the taxes saved would probably be \$100 or less.

The previous examples all assume a \$1,000 level to provide some basis for comparison among various tax provisions. But actual savings for individual families depend on how much they spend and on whether there are limits to the amount they can apply to tax savings. A gift of \$10,000, for example, would be worth more in tax savings to a high-income family—perhaps \$3,000—than the \$500 gained from the \$1,000 personal income tax exemption. Similarly, borrowing more than

\$1,000 would raise the amount of taxes that could be saved from interest deductions.

How would proposed new tax breaks affect enrollment behavior and the amount of money families save for college expenses? Deductions for savings are probably the only measures that would appreciably affect the amount that families invest in higher education. A tax break of \$700 or so per \$1,000 contributed might serve as a powerful stimulant for additional savings and investment in higher education. If a maximum contribution of \$2,000 were allowed, the roughly \$1,400 in tax savings that could result would represent 10 percent or more of the annual costs at a fairly expensive private college. By contrast, families would be less likely to be influenced by the \$250 saved through a tax credit because it would represent a far smaller share of the cost of attendance.

The administration's tax-free income approach would also not likely have much of an impact since it would save families a relatively small amount in taxes when compared to college costs, especially if annual contributions were capped at \$1,000 as the administration proposes. Most families might simply shift some of their savings into these tax-free accounts rather than substantially increase their overall rate of saving. Or parents might provide less in the form of gifts and place these funds instead in the tax-free accounts. In either case, creation of tax-free savings accounts, if limited to \$1,000 annually, would probably not result in any appreciable increase in savings for college costs.

The revenue loss from tax provisions—both in total and per beneficiary—helps to provide a picture of the potential effectiveness of various tax provisions. But the equity of a particular tax provision can be measured by finding out who receives the tax benefits. This report estimates the degree to which both current and proposed tax breaks for college benefit families with incomes above the national median. The median figure used in these estimates is for all families, not just those with college-age children. The median income for all families in 1982 was approximately \$23,000, and we estimate that approximately 65 percent of families with children in college had incomes above that figure.

Table 2 displays estimates of the percentages of tax savings for families with incomes above the median. These estimates are based on the dollar value of tax breaks to high- and moderate-income families, the extent to which families use these provisions, and the distribution of income for families with children in college compared to the population in general.

Of existing tax provisions, only benefits from the exclusion of scholarship and fellowship assistance accrue primarily to lower-income families. In this case, the fact that lower-income families receive most of this aid more than offsets the fact that higher-income families receive more of a tax break per dollar of assistance due to their higher tax brackets. For employer-provided educational expenses, families with incomes below the median probably receive about half of the tax benefits.

All the other existing tax provisions, however, probably go disproportionately to families with incomes above the median. The extension of dependent exemption

Distribution of Benefits by Family Income

status, while it is \$1,000 for all students, benefits higher-income families more since they are in higher tax brackets—about 75 percent of the tax savings from this provision go to families above the median-income level. Deductions for interest on student loans are available only to those individuals who itemize their deductions, and such people generally have above-average incomes. The provisions that allow parents to shift incomes to their children are the domain of the well-to-do; we estimate 90 percent of tax savings from these provisions go to families above the median. When the relative size (in terms of revenue loss) of existing provisions is taken into account, 65 percent of the tax savings go to families above the median, roughly the same as their share of postsecondary attendance.

Among proposed changes to the tax code, tax credits are the least regressive since families below the median receive the same dollar amount of tax break as wealthier families. The relative fairness of the tax credit approach is increased if the credit is refundable to families that have little or no tax liability. The 65 percent estimate provided in Table 2 assumes refundability so that distribution of benefits is roughly the same as the income distribution of all college attendees.

The other proposed tax breaks for college would go in greater proportions to higher-income families. The administration's proposal to limit the maximum benefit in its tax-free accounts to families below \$40,000 would help make the plan more equitable, but about 80 percent of the tax savings would still likely go to

Table 2. Estimated Distribution of Tax Savings by Family Income

Existing Provisions	Percent of Tax Savings Going to Families with Above-Median Incomes
Extension of dependent status for college students	75
Exclusion of scholarship and fellowship assistance	25
Deduction of interest on student loans	85
Job-related educational assistance	50
Shifting income from parents to children	90
Average for existing provisions	65
Proposed Changes	
Tax credits for current tuition expenses	65
Tax deductions for college saving	85
Tax-free income on college saving accounts	80

Source: Author's estimates.

families above the median. In the case of tax deductions for college saving, the large difference in the size of benefits for high- and moderate-income families suggests that a very large percentage of benefits will accrue to wealthier families. Even with a 5-percent set-aside dedicated to a scholarship fund for needy students, as much as 85 percent of the benefits from a tax deduction savings plan might go to families with incomes above the median.

Tax provisions cannot be viewed in isolation from other policies, in particular the student aid programs that influence decisions about college. The federal government spends more for student aid programs than it loses in revenue from tax expenditures related to postsecondary education; in fiscal 1982 federal expenditures for all student aid programs were roughly \$7 billion, compared to less than \$2 billion in revenue loss that resulted from tax breaks for college. The two largest student aid programs—Pell Grants and Guaranteed Student Loans—each separately cost the government more each year than the total combined revenue loss from all existing tax breaks.

Student aid programs can be a much more direct and effective way for the government to encourage college enrollments. A grant of \$1,000 reduces the price that students and their families pay for college much more than a tax advantage accruing from a \$1,000 investment in postsecondary education. Even the most substantial tax break—tax-protected contributions to special accounts—would only result in about \$700 for every \$1,000 contributed. All other tax provisions, since they are of even less value, suffer more in comparison with a direct grant.

When students borrow in the Guaranteed Student Loan program, they are subsidized through below-market interest rates and the fact that they pay no interest while they remain in school and for six months thereafter. These interest subsidies, which vary in value depending on how long the borrower remains in school, can be quite substantial. They can be worth 50 percent or more of the face value of the loan on a present value basis. Thus, a loan of \$1,000 carries an implicit subsidy of \$500 or more over the life of the loan. Like grants, loan subsidies are worth a great deal more than the taxes saved through most of the tax provisions already discussed.

In terms of the income distribution of benefits, tax provisions for families with children in college reach a much different group than student aid programs do. The majority of tax benefits go to wealthier families; approximately 65 percent of benefits from existing tax provisions go to families with income above the median. Most proposed tax breaks would favor high-income groups even more. By contrast, student aid programs are distributed predominantly to families with incomes below the median. About 10 percent or fewer of Pell Grant recipients have incomes above the median level. Even in the GSL program, the student aid program most utilized by middle- and upper-income families, probably less than half the recipients come from families with incomes above the median, especially since families with incomes above \$30,000 must now meet a test of financial need in order to qualify.

Tax Provisions vs. Student Aid Programs

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